AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence

Alfred Nzo District Municipality

Audit Report

For the year ended 30 June 2016

Report of the auditor-general to the Eastern Cape Provincial Legislature and the council of Alfred Nzo District Municipality on the Alfred Nzo District Municipality

Report on the consolidated and separate financial statements

Introduction

1. I have audited the consolidated and separate financial statements of the Alfred Nzo District Municipality and its entity set out on pages ... to ..., which comprise the consolidated and separate statement of financial position as at 30 June 2016, the consolidated and separate statement of financial performance, statement of changes in net assets, and cash flow statement and statement of comparison of budget information with actual information for the year then ended, as well as the notes, comprising a summary of significant accounting policies and other explanatory information.

Accounting officer's responsibility for the consolidated and separate financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2014 (Act No. 10 of 2014) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of the consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

Auditor-general's responsibility

3. My responsibility is to express an opinion on these consolidated and separate financial statements based on my audit. I conducted my audit in accordance with International Standards on Auditing. Those standards require that I comply with ethical requirements, and plan and perform the audit to obtain reasonable assurance about whether the consolidated and separate financial statements are free from material misstatement.

4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated and separate financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated and separate financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated and

separate financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated and separate financial statements.

5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for qualified opinion

Irregular expenditure

6. The municipality did not have adequate systems to identify and disclose all irregular expenditure incurred during the year, as required by section 125(2)(d)(i) of the MFMA. The irregular expenditure for the current and prior year, disclosed in note 47 to the consolidated and separate financial statements, is understated. Due to the lack of systems, it was impracticable to determine the full extent of the understatement of the irregular expenditure. Consequently, I was unable to determine whether any further adjustments were necessary to the current and prior year irregular expenditure of R591,2 million (2015: R398,6 million), as disclosed in note 47 to the consolidated and separate financial statements.

Property, plant and equipment

7. The municipality did not account for property, plant and equipment in accordance with GRAP 17, *Property, plant and equipment,* as disclosed in note 3, and the following deficiencies were identified:

    - Operating expenses were incorrectly capitalised to assets under construction
    - The fixed asset register did not agree to the financial statements
    - The useful lives of assets with zero values were not reassessed
    - Assets were duplicated in the fixed asset register
    - Assets under construction were not accurately reported.

8. As a result, property, plant and equipment is overstated by R522,6 million (2015: R426,1 million), operating expenses are understated by R37 million and accumulated surplus, as disclosed in the statement of financial position and financial performance, is overstated by R485,6 million (2015: R426,1 million).

9. In addition, the municipality did not comply with the requirements of GRAP 17, *Property, plant and equipment* relating to the categorisation of assets. Completed assets were not transferred to infrastructure assets from assets under construction. As a result, infrastructure assets disclosed in note 3 are understated by R105,2 million (2015: R69,2 million) and assets under construction, as disclosed in note 3, are overstated by R105,2

million (2015: R69,2 million).

Payables from exchange transactions

10. The municipality did not have adequate systems to maintain records of accounts payable for goods and services received but not yet paid for, which resulted in trade payables and general expenses being understated by at least R41,5 million (2015: R68,2 million). It was impracticable for me to determine the full extent of the understatement in payables from exchange transactions and general expenses, as disclosed in note 18 to the consolidated and separate financial statements.

Commitments

11. GRAP 17: *Property, plant and equipment* requires the disclosure of contractual commitments for the acquisition on property, plant and equipment. An adequate record of commitments was not maintained and reviewed for accuracy and completeness by the municipality for the year under review. Invoices inspected did not agree to the disclosed amounts in the commitments register and not all commitments have been recorded in the register. This resulted in an understatement of R1,27 billion (2015: R195,4 million) of commitments disclosed in note 39 to the consolidated and separate financial statements.

12. In addition, I was unable to obtain sufficient appropriate audit evidence for the amount disclosed as commitments in note 39 to the separate financial statements as requested information was not submitted and I could not confirm the disclosure by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to commitments of R612,6 million (2015: R848,7 million), as disclosed in note 39 to the consolidated and separate financial statements.

Employee benefits

13. GRAP 25, *Employee benefits* allows a municipality to disclose multi-employer defined benefit plans as defined contribution plans if certain disclosures are made. The municipality belongs to a number of multi-employer plans which meet the definition of defined benefit plans. The municipality has not made all the disclosures as required by GRAP 25, *Employee benefits*.

Qualified opinion

14. In my opinion, except for the effects of the matters described in the basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Alfred Nzo District Municipality as at 30 June 2016 and its financial performance and cash flows for the year then ended, in accordance with the SA standards of GRAP and the requirements of the MFMA and DoRA.

Emphasis of matters

15. I draw attention to the matters below. My opinion is not modified in respect of these matters.

Restatement of corresponding figures

16. As disclosed in note 42 to the consolidated and separate financial statements, the corresponding figures for 30 June 2015 have been restated as a result of an error discovered during 30 June 2016 in the consolidated and separate financial statements of the municipality at, and for the year ended, 30 June 2015.

Material losses

17. As disclosed in note 8.1 to the consolidated and separate financial statements, material losses to the amount of R50 million (2015: R37,2 million) were incurred as a result of water losses.

Financial sustainability

18. As disclosed in note 44.1 to the consolidated and separate financial statements, the municipality is facing a number of financial risks that cast doubt on its ability to sustain its current level of operations in the near future. The key financial risks identified include:

    - an inability to pay creditors within due dates
    - negative key financial ratios, including a net current liability position.

    In addition, the actions taken by management to mitigate the impact of these risks are disclosed in this note.

Additional matter

19. I draw attention to the matter below. My opinion is not modified in respect of this matter.

Unaudited disclosure notes

20. In terms of section 125(2)(e) of the MFMA, the municipality is required to disclose particulars of non-compliance with this legislation. This disclosure requirement did not form part of the audit of the separate financial statements and, accordingly, I do not express an opinion thereon.

Report on other legal and regulatory requirements

21. In accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and the general notice issued in terms thereof, I have a responsibility to report findings on the reported performance information against predetermined objectives of selected programmes presented in the annual performance report, compliance with legislation and internal control. The objective of my tests was to identify reportable findings as described under each subheading, but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

Predetermined objectives

22. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information of the following selected programme presented in the annual performance report of the municipality for the year ended 30 June 2016:

    - Programme 2: Basic service delivery (Infrastructure and municipal services) on pages x to x

23. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned programmes. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the National Treasury's *Framework for managing programme performance information* (FMPPI).

24. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.

25. The material findings in respect of the selected programme are as follows:

Basic service delivery (Infrastructure and municipal services)

Usefulness of reported performance information

26. The FMPPI requires that performance indicators should be well defined by having clear definitions so that data can be collected consistently and is easy to understand and use. A total of 26% indicators were not well defined due to a lack of technical indicator descriptions.

27. The processes and systems that produced the indicator should be verifiable, as required by the FMPPI. A total of 45% indicators were not verifiable. This was because the municipality does not have standard operating procedures and maintain proper record keeping.

Reliability of reported performance information

28. The FMPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. The reported performance information was not valid, accurate and complete when compared to the source information or evidence provided. This was due to a lack of standard operating procedures and frequent review of the validity of reported achievements against source documentation, as well as a lack of integration of departments within the municipality.

Additional matters

29. I draw attention to the following matters:

Achievement of planned targets

30. Refer to the annual performance report on pages x to x for information on the achievement of planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information in paragraphs 27, 28 and 29 of this report.

Adjustment of material misstatements

31. I identified material misstatements in the annual performance report submitted for auditing. These material misstatements related to the reported performance information of infrastructure and municipal services. As management subsequently corrected only some of the misstatements, I raised material findings on the usefulness and reliability of the reported performance information.

Unaudited supplementary information

32. The supplementary information set out on pages x to x does not form part of the annual performance report and is presented as additional information. I have not audited these schedules and, accordingly, I do not report on them.

Compliance with legislation

33. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My material findings on compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

Annual report and annual financial statements

34. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements identified by the auditors in the submitted financial statements were not adequately corrected and the supporting records could not be provided subsequently, which resulted in the financial statements receiving a qualified audit opinion.

35. The annual performance report for the year under review did not include the performance of the municipality entity, as required by section 46 (1) (a) of the Municipal Systems Act (MSA).

Revenue management

36. Interest was not charged on all accounts in arrears, as required by section 64(2)(g) of the MFMA.

Expenditure management

37. Reasonable steps were not taken to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

38. An adequate management, accounting and information system was not in place which accounted for creditors, as required by section 65(2)(b) of the MFMA.

39. An effective system of expenditure control, including procedures for the payment of funds, was not in place, as required by section 65(2)(a) of the MFMA.

40. Money owed by the municipality was not always paid within 30 days, as required by section 65(2)(e) of the MFMA.

Asset and liability management

41. An effective system of internal control for assets and liabilities was not in place, as required by section 63(2)(c) of the MFMA.

Consequence management

42. Unauthorised, irregular and fruitless and wasteful expenditure incurred by the municipality was not investigated to determine whether any person was liable for the expenditure, as required by section 32(2)(a) and 32(2)(b) of the MFMA.

Procurement and contract management

43. I could not obtain sufficient appropriate audit evidence that all contracts were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as the municipality does not have a proper record-keeping system in place.

44. Invitations for competitive bidding were not always advertised for a required minimum number of days, in contravention of supply chain management (SCM) regulation 22(1) and 22(2).

45. I could not obtain sufficient appropriate audit evidence that contracts were awarded to suppliers based on preference points that were allocated and calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act and its regulations.

46. I could not obtain sufficient appropriate audit evidence that the preference point system was applied in all procurement of goods and services above R30 000, as required by section 2(a) of the Preferential Procurement Policy Framework Act and SCM regulation 28(1)(a).

47. I could not obtain sufficient appropriate audit evidence that contracts were only extended or modified after tabling the reasons for the proposed amendment in the council of the municipality, as required by section 116(3) of the MFMA.

48. I could not obtain sufficient appropriate audit evidence that all extensions or modifications of contracts were approved by a properly delegated official, as required by SCM regulation 5.

49. I could not obtain sufficient appropriate audit evidence that contracts were awarded to bidders that scored the highest points in the evaluation process, as required by of section 2(1)(f) of Preferential Procurement Policy Framework Act.

50. Persons in service of the municipality whose close family members had a private or business interest in contracts awarded by the municipality failed to disclose such interest, in contravention of SCM regulation 46(2)(e).

51. The performance of contractors or providers was not monitored on a monthly basis, as required by section 116(2)(b) of the MFMA.

52. The contract performance and monitoring measures and methods were insufficient to ensure effective contract management, in contravention of section 116(2)(c) of the MFMA.

53. Measures to combat the abuse of the SCM system were not implemented as per the requirements of SCM regulation 38(1), because sufficient appropriate audit evidence could not be obtained that awards were made to providers who:

    - had not during the last five years failed to perform satisfactorily on a previous contract with the municipality
    - had not committed a corrupt or fraudulent act in competing for the contract
    - had not abused the SCM system of the municipality
    - had not been convicted of fraud or corruption during the past five years.

Internal control

54. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the basis for qualified of opinion, the findings on the annual performance report and the findings on compliance with legislation included in this report.

Leadership

55. Leadership did not take full ownership of the general control environment and did not insist on daily disciplines to ensure efficiency and effectiveness in financial management, service delivery execution and compliance with laws and regulations. Consequently, the correct tone was not set to ensure that officials are held accountable for their actions through a consequence management programme.

56. Furthermore, leadership did not investigate transgressions identified in order to take action where necessary against officials and promote a high standard of ethics.

57. There was a prolonged vacancy in the key position of chief financial officer (CFO), which resulted in leadership instability that undermined accountability. This vacancy resulted in inadequate direction and guidance within the municipality to execute its strategies and operations. In addition, the support provided by consultants did not yield the desired results as leadership did not introduce all the required mechanisms to ensure that consultants deliver expected outputs.

58. The municipality did not have an effective performance management system in place to promote accountability and good human resource management that promote career development and maximise staff potential.

59. In addition, the municipality did not implement and monitor the audit action plan and, as a result, numerous internal control deficiencies identified in the previous year recurred in the current year.

Financial and performance management

60. A lack of daily, weekly and monthly of financial discipline and monitoring throughout the financial year resulted in a large number of reconciliations, journals and corrections being performed after year-end. In addition, leadership did not ensure that the consolidated and separate financial statements agreed to supporting documentation prior to its submission for audit.

61. The municipality did not have a proper record management system to ensure that complete, relevant and accurate information was accessible and available to support financial and performance reporting. This resulted in some amounts disclosed in the financial statements not being supported by relevant accounting records.

62. The municipality did not have review and supervision processes to monitor compliance with all applicable legislation. As a result, non-compliance with laws and regulations was not effectively identified or prevented and municipal officials were not held accountable for transgressions in this regard.

Governance

63. The municipality did not have adequate risk management processes in place. As a result, there were no processes to identify all risks to which the municipality was exposed and no mitigating controls were in place for the risks that had been identified.

64. The internal audit unit was not effective in its review of internal controls and compliance with legislation. This was largely as a result of a lack of cooperation from management and capacity shortages in terms of skills and resources within the unit.

65. The impaired functioning of the internal audit unit impacted the effectiveness of the audit committee.

AUDITOR-GENERAL

East London

9 December 2016

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